RB 2014-01 Guidance on Direct Loan Referral Programs

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Guidance on Direct Loan Referral Programs

Introduction

This guidance reminds credit unions of the process they should follow to prudently manage the risks associated with direct loans based on a referral from an independent dealer. While there are benefits to a well-run loan referral program, an improperly managed or loosely controlled program can quickly lead to unintended risk exposure. This can increase credit risk, liquidity risk, transaction risk, compliance risk, and reputation risk. It takes proper planning and appropriate controls and monitoring to make this type of program profitable and a productive activity for serving members.

Background

During periods of reduced net interest margins, stagnant growth in traditional loan products, and increased competition, credit union management and directors face many challenges in seeking to improve the credit union's financial performance. Engaging in new or modified credit union products or services is often considered a solution. However, if management and the board are overly focused on expected returns, do not have a good understanding of the inherent risk, or have poor governance practices, the credit union's ability to effectively measure, monitor, and control the risks

inherent in such products or services may be compromised.

Recently, the Department has seen credit unions that have not performed the necessary up-front analysis to determine whether a loan referral program offers the appropriate risk-versusreturn profile, and is consistent with the credit union's strategic direction. Additionally, some credit unions have failed to implement appropriate risk management controls and In some cases, these oversight failures have resulted in costly errors, unwarranted risk exposure, and deviations from the credit union's business plan. historically well-managed credit unions have found themselves faced with problems because credit union management underestimated its need to manage, monitor, and control the development and implementation of a program. Instead of boosting net income, the product or service caused systems and control problems, resulting in credit losses, compliance issues, litigation exposure, unfavorable returns, and diminished reputation in the community.

Loan Referral Program

In broad terms, a direct loan referral program occurs as a result of a credit union setting up a direct referral relationship with a properly licensed dealer. The dealer refers members or potential members to obtain a loan directly from the credit union to purchase a vehicle (automobile, recreational vehicle, boat, motorcycle, etc.) from the dealer. Depending on the specifics of a given program, the dealer may or may not receive compensation for this referral activity; however, the credit union controls the entire credit extension process (underwriting) from the initial loan application to the credit investigation, to the new member visiting the credit union to open their account and close the loan.

Field of Membership

A credit union may only make loans to its members, and, as such, direct loan referral applicants must meet the field of membership requirements included in the credit union's bylaws and must become members of the credit union. Evidence of the prospective borrower opening a credit union membership account must be retained, along with all other pertinent documentation. As a reminder, credit unions must obtain all necessary information and follow all procedures for opening accounts as required under applicable law, including the Bank Secrecy Act, as amended by the USA PATRIOT Act, its implementing regulations, and any directives that may be issued. These requirements are in addition to the documents and disclosures required to be given or completed in conjunction with the loan transaction.

Sound Business Practices

The Department expects credit union management and the board to oversee all new, expanded, or modified products and services through an effective risk management process. An effective risk management process includes: (1) performing adequate due diligence prior to introducing the product or service, (2) developing and implementing controls and processes to ensure risk are properly measured, monitored, and controlled, and (3) developing and implementing appropriate performance monitoring and review systems. The formality of the credit union's risk management process should reflect the size of the credit union and the complexity of the product or service offered.

Credit unions should also take measures to ensure careful review and understanding of any contract or legal issues relevant to a dealer referral program. It is prudent to seek qualified legal counsel to review dealer arrangements and contracts.

Due Diligence

Prior to entering into any direct loan referral program, credit union management and the board should conduct due diligence to ensure they have a realistic understanding of the risks and rewards of the program. In addition, a credit union should conduct sufficient due diligence to determine whether it wishes to be associated with the quality of vehicles, services, and business practices of the dealer. The due diligence process should also include developing viable alternatives, including an exit strategy, in the event the referral program fails to perform as expected. Also, the credit union should determine whether the dealer has the necessary licenses to operate. NCUA Letter to Credit Unions 07-CU-13 titled "Evaluating Third Party Relationships" provides pertinent information on effective third party due diligence.

Analyze Impact on Net Worth

It is the Department's position that sound business practices for direct loan referral program requires a credit union to assess the potential risk to its net worth by analyzing appropriate factors, including:

- The interest rate that will be charged;
- Delinquencies and charge-offs;
- Loan prepayments;
- Insurance premium;
- Program fee; and
- Other costs, such as for due diligence.

Estimating how all these factors interrelate is complex, particularly for a direct loan referral program. Be aware that when a credit union has evaluated all these factors the expected return may be negative. This is the risk to net worth.

Policies and Procedures

Successful lending programs rely on well developed policies and practices. The credit union's direct loan referral policy should establish specific underwriting standards and clear requirements for direct loans based upon a dealer referral.

These lending standards should be consistent with the credit union's internal loan underwriting standards. The standards should be reviewed at least annually or more often if risk levels increase or if negative trends begin to surface.

The board and management should also develop detailed policy guidance sufficient to outline expectations and limit risks originating from this program. Policies and procedures should outline staff responsibilities and authorities for the referral processes and program oversight. Additionally, policy guidance should define the content and frequency of reporting to the board. Credit unions should also establish program limitations to control the pace of program growth and allow time to develop experience with the program. For example, some of the primary considerations a credit union should consider with respect to direct loan referral program are:

- Total dollar limits on the program (i.e. set the limit in relationship to net worth, total loans, etc.);
- Maximum growth limits;
- 3. Minimum credit score limits;
- 4. Minimum debt-to-income ratio limits;
- Maximum loan-to-value ratio limits;
- Maximum exposure from any one dealer;
- 7. Verification of the condition and market value of the vehicle:
- 8. Acceptable age of vehicles taken as collateral;
- 9. Acceptable maturities for direct loan referrals;
- 10. Pricing to reflect all costs related to the program;
- 11. Prohibition on the dealer receiving borrower's loan

payments;

- 12. Prohibition on the dealer making payment on behalf of the borrower;
- 13. Prohibition on any credit union staff or official from, directly or indirectly, receiving consideration for the credit union making a specific loan;
- 14. Permissibility of selling any repossessed vehicle back to a dealer;
- 15. Verification of sale price;
- 16. Insurance requirements; and
- 17. Lien perfection.

Customer Service Complaints

Credit unions should also have plans to respond to member complaints, including those regarding the quality of the vehicles or services provided by the dealer. The plan also should address how the credit union will address complaints regarding false or misleading advertising, or other alleged misconduct by the dealer.

Dealer relationships that do not meet the expectations of the credit union's members expose the credit union to reputation risk. Poor service, inappropriate sales tactics, and violations of laws can result in negative perceptions in the community. Publicity about adverse events surrounding the dealer also may increase the credit union's reputation risk.

Performance Monitoring

Credit union management and the board should have appropriate performance and monitoring systems in place to allow them to assess whether the program is meeting operational and strategic expectations. The Department expects that these systems will track each dealer regarding:

 Number of applications submitted, approved, conditioned, and denied;

- 2. Total loans outstanding;
- Delinquency;
- 4. First payment defaults;
- 5. Repossessions;
- Charge-offs;
- 7. Average loan to value;
- 8. Average loan term; and
- 9. Average credit score.

The board should be provided information pertaining to the program (i.e. loans processed, approved, rejected, booked, delinquency, repossessions, etc.) on a periodic basis.

Summary

When a credit union engages in any lending activity, it should be compatible with a credit union's risk tolerance, administrative capabilities, and strategic goals. The projected and realized impact on a credit union's financial performance should be analyzed regularly. Reasonable program limits should be established as well as on-going program monitoring and analysis.

Examiners will assess whether a credit union involved in direct loan referral programs has adequately planned for, and is monitoring and controlling this activity. Management will be adversely rated for a failure to manage and control this type of lending.